Once Upon a Time... of Fed Easing

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

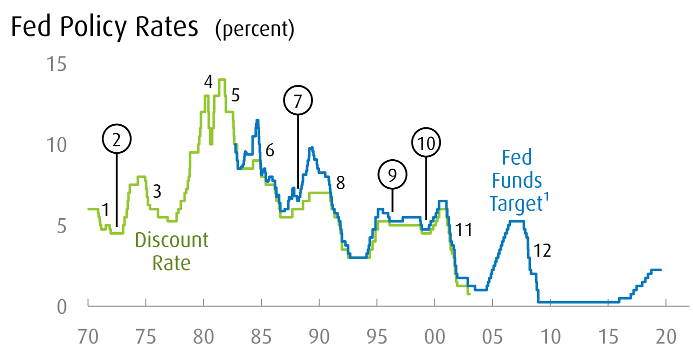
ECONOMIC RESEARCH
1-800-613-0205
economics.bmo.com

Douglas Porter, CFA, Chief Economist
+1 (416) 359-4887
douglas.porter@bmo.com

The Fed is almost universally expected to clip interest rates at next week's FOMC meeting, with most of the lingering debate now over the size of the first step, and whether it will be accompanied by any additional measures. For the record, **we lean to a simple 25 bp trim to start**, but readily recognize that the Fed has surprised many times on the easier side of the ledger so far in 2019. Looking beyond next week's moves, the more interesting question is **what comes next—will this be just the first in a series of cuts, how long will the easing cycle last, how might markets respond, and when could the Fed realistically begin hiking again?** To address these issues, and many others, let's look back at past easing cycles.

Below, in Tables 1 and 2, we consider the 12 separate and distinct easing cycles that can be identified over the past fifty years (*Chart 1*). Because rates were so volatile in the 1970s and 80s, and there were numerous mini cycles, we used changes in the discount rate to identify the start and end points of easing cycles for much of those two decades (and the Fed funds rate after the mid-80s). We have further split the easing cycles into mini and major cycles, with those with less than 100 bps of total easing placed in the first category (the shaded rows). The only one of the 12 which falls somewhere in between is the very first one in 1970/71, but it just qualifies as a major cycle (at 125 bps of easing from a starting point of 6.0%). Easing cycles are deemed to officially end only after the last rate cut before they started moving higher again.

Chart 1
12 Easing Steps



O = mini cycles [1] Upper limit
Sources: BMO Economics, Haver Analytics

There are a few major conclusions which jump out. First, the easing cycle itself:

- Exactly half of the 12 easing cycles started with a 25 bp trim, four with a larger 50 bp move, and two with a full 100 bp cut (both the early 1980s cycles, when rates were starting in the double digits).
- Full easing cycles have been as small as 50 bps (1971), and as large as 681 bps (1989-92). As a share of the starting rate, mini cycles have seen net cuts of little more than a tenth, while major easing cycles have been as moderate as a 21% slice, all the way up to almost a 100% cut (in the 2007-08 financial crisis).
- In terms of duration, half of the cycles have been done in six months or less, while the 1989-92 cycle dragged on for more than three years. A "normal" major easing cycle lasts about 18 months.

Table 1
Twelve Easy Steps: Part One

	Start of Fed Easing Campaign	Starting Rate (%)	First Cut Size (bps)	Total Cuts (bps)	Last Cut	Easing Cycle (months)	Next Hike	Time Gap (months)
Discount Rates								
1	Nov. 13, 1970	6.00	25	125	Feb. 1971	3	July 1971	5
2	Nov. 19, 1971	5.00	25	50	Dec. 1971	2	Jan. 1973	13
3	Dec. 9, 1974	8.00	25	275	Nov. 1976	23	Aug. 1977	9
4	May 30, 1980	13.00	100	300	July 1980	3	Sep. 1980	2
5	Nov. 2, 1981	14.00	100	550	Dec. 1982	13	Apr. 1984	16
6	Nov. 21, 1984	9.00	50	250	Aug. 1986	21	Sep. 1987	13
Fed Funds								
7	Nov. 4, 1987	7.31	50	81	Feb. 1988	4	Mar. 1988	1
8	June 6, 1989	9.81	25	681	Sep. 1992	39	Feb. 1994	17
9	July 6, 1995	6.00	25	75	Jan. 1996	6	Mar. 1997	14
10	Sep. 29, 1998	5.50	25	75	Nov. 1998	3	June 1999	7
11	Jan. 3, 2001	6.50	50	550	June 2003	29	June 2004	12
12	Sep. 18, 2007	5.25	50	513	Dec. 2008	15	Dec. 2015	84
Median	Mini cycles	5.75	25	75		4		10
	Major cycles	8.50	50	406		18		13
July 2019		**2.38**	**25?**	**50?**		**4?**		

Shading marks mini easing cycles

Table 2
Twelve Easy Steps: Part Two

	Start of Fed Easing Campaign	Jobless Rate At Start (%)	Jobless Rate vs. 6 Mo. Prior (ppts)	S&P 500 (% chng) 6 Months Prior	S&P 500 (% chng) 6 Months After	10-yr Treasury Yield (bps) 6 Months Prior	10-yr Treasury Yield (bps) 6 Months After	First Cut (% of starting rate)	Full Easing (% of starting rate)
Discount Rates									
1	Nov. 13, 1970	5.5	0.9	10.5	20.8	-86	-93	4.2	21
2	Nov. 19, 1971	5.8	-0.1	-9.6	18.3	-70	33	5.0	10
3	Dec. 9, 1974	6.6	1.5	-29.1	40.3	-6	19	3.1	34
4	May 30, 1980	6.9	0.9	4.1	27.4	-9	248	7.7	23
5	Nov. 2, 1981	7.9	0.7	6.9	16.3	52	-68	7.1	39
6	Nov. 21, 1984	7.4	-0.3	-6.4	-4.2	111	171	5.6	39
Fed Funds									
7	Nov. 4, 1987	6.0	-0.3	-15.7	3.8	40	-1	6.8	11
8	June 6, 1989	5.2	-0.1	16.8	6.6	-59	-42	2.6	69
9	July 6, 1995	5.6	0.1	20.2	11.3	-177	-36	4.2	13
10	Sep. 29, 1998	4.5	-0.1	-4.1	25.4	-108	68	4.6	14
11	Jan. 3, 2001	3.9	-0.1	-12.7	-6.3	-108	25	7.7	85
12	Sep. 18, 2007	4.6	0.3	8.4	-9.9	-8	-100	9.6	96
Median	Mini cycles	5.7	-0.1	-6.9	14.8	-89	16	4.8	12
	Major cycles	6.1	0.5	5.5	11.5	-9	-12	6.4	39
July 2019 (data as of July 26)		**3.7**	**-0.2**	**14.2**		**-67**		**10.7**	**21?**

Shading marks mini easing cycles

- As Table 2 shows, the easing cycles have typically begun at a higher jobless rate (averaging almost 6%), but it hasn't always been rising in the six months prior to rate cuts. In fact, ahead of the four mini easing cycles, the jobless rate had typically been flat-to-down in the lead-up to the rate cuts (as is the case in the current episode).

Second, how the markets react:

- Perhaps the single biggest takeaway from past easing cycles is that equities have tended to rise six months after the rate cuts began while bond yields have been nearly flat on average—both in mini and in major easing cycles. In 7 of the 12 cycles, the S&P 500 has posted double-digit advances in the following six months. However, note that the two most recent cycles have run against that grain.

- Bond yield outcomes have been much less one-sided, with no clear tendency to rise or fall in the six months following the first cut in either mini or major cycles. Again, note that the biggest exception was the most recent cycle in 07/08.

- Both stand in contrast to market moves in the lead-up to the first rate cut, where stocks have been mixed on average in the six months before the easing cycle began. That may run a bit counter to perceptions, as there were some dramatic episodes of deep declines (which in at least one case was the main driver of Fed easing (1987)). But there have also been a number of easing cycles that began with equities in strong shape, as is clearly the case in 2019.

- The recent deep drop in bond yields also lines up reasonably well with the majority of past easing cycles—9 of the 12 saw yields falling (often heavily) in the six months prior to the first rate cut. Indeed, the slide in Treasury yields this year is quite close to the median drop seen over the past 12 easing cycles.

We believe that this will ultimately be a mini easing cycle, officially calling for just one more move in October, although the market is priced for roughly 100 bps of cuts over the next year. The **deciding factor** for whether the rate cuts morph into a major cycle, not surprisingly, will be **how the underlying economy fares** in the next 6-12 months. While financial markets have tended to react in a reasonably uniform fashion after the start of easing cycles, the economy has not—in the four mini cycles, the jobless rate was slightly lower in the six- and 12-months after rate cuts began. However, in the cycles that morphed into major rate cut campaigns, the jobless rate was half a point *higher* six months after the first cut on average, and was almost a full point higher one year later. At this point, we are projecting just a 0.1 ppt increase in the jobless rate a year from now, and thus only modest rate trims; but we are also assuming no further deterioration in the trade wars.

Looking beyond this year's expected rate cuts, if this does indeed remain a mini easing cycle, past episodes suggest that the Fed could conceivably be *hiking* rates again by late next year or early 2021. **The typical easing cycle**—both mini and major—**has seen the Fed begin to tighten again within roughly a year of the last rate cut.** Again, the glaring exception to the rule was the most recent cycle, when the Fed was forced to wait seven long years between the last rate cut in 2008 and the first rate hike in late 2015.

Bottom Line: There is no foolproof fixed playbook for Fed easing cycles, as every episode has its own quirks and special features. And there are some unusual aspects to the beginning of this Fed easing cycle—the extreme low starting level for both the jobless rate and interest rates. But, there are also many features that rhyme with historical precedent. Market behaviour has been close to the norm heading into easing campaigns, as has the trend in the jobless rate, at least compared with mini easing cycles... which this one is expected to mirror.

Coda: It may seem a tad surprising that the Fed is poised to ease just a bit more than 7 months after the December 19 rate hike. Yet, in the 12 easing cycles studied above, the median spread between the last rate hike of the prior tightening cycle and the first rate cut of the next was just 7 months (with a range of 1 to 18 months). So, from that standpoint at least, this cycle looks to fit the playbook perfectly.